Pensions CIV Sectoral Joint Committee

Item no: 5

Finance Report

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Date:	13 September 2017		
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Summary: This report provides the Committee with a finance update on delivery against the 2017/18 business plan and MTFS.

Recommendations: The committee is recommended to note and discuss the contents of this report.

Section 1. Financial Report for the four months to 31st July 2017

1. The profit before tax is £591k compared to the MTFS budget of £222k, showing a positive variance of £369k.

Actual Results for the four months to July 2017 INCOME	YTD July Actual	MTFS to July	Variance
Service Charge	266,667	266,667	-0
Development Funding Charge	800,000	800,000	0
	1,066,667	1,066,667	-0
Management Fee by Fund			
Active Equity	258,234	254,517	3,717
Multi-Asset	113,689	99,601	14,088
LGIM Passive	83,199	0	83,199
Total Management Fee	455,121	354,118	101,003
Total Income	1,521,788	1,420,785	101,003
EXPENSE			
Staff Costs	513,502	668,824	155,322
Facilities	102,309	119,752	17,443
Legal and Professional	253,660	315,758	62,097
Travel, marketing and general expenses	12,618	17,924	5,306
Technology costs	12,067	44,229	32,162
Data Feeds and other information services	37,154	36,585	-569
Total Operating Expenses	931,311	1,203,071	271,760
Operating Profit	590,477	217,713	372,764
Depreciation	720	613	106
Interest Income	2,038	5,000	-2,962
Profit before tax	591,796	222,100	369,696

2. The principle reasons for the variance are:

   i. As noted at the July meeting, LCIV's agreed fee for negotiating lower fees with LGIM was not included in the MTFS and continues to be a positive variance,

   ii. Timing differences arising on staff recruitment which were budgeted to start at the beginning of the financial year,

   iii. Professional fees in respect of fund launches being charged to funds with effect from 1st April 2017 rather than being expensed in the management company and

   iv. Technology costs not yet incurred as the work on the operating model and systems development has yet to commence.

Income

3. The details of income variances are highlighted as follows:

   i. The service charge and DFC are in line with the MTFS. The service charge is billed annually in advance and recorded on an accruals basis.

   ii. The variance in active equity management fees arises from the increase in asset values over and above the MTFS (£4.7bn MTFS, £5.2bn actual) despite the small delays in the launch of Longview, Majedie and Newton which were budgeted for the beginning of April launch but transitioned at the end of May.

   iii. The positive variance on passive equity management fees relates to the LGIM fees which were not included in the MTFS as the fee charging arrangement had not been agreed at the time of the sign-off of the MTFS.

Expenses

4. The details of expense variances are highlighted below:

   i. **Staff expenses** – the MTFS had assumed a number of hires (5) effective the beginning of Q1 and a further four hires in Q2. The actual hiring was four so that staff recruitment was five under budget. The financial impact of the variation of timing in hiring has resulted in a cost saving of £150k.

   ii. **Facilities** – the arrangement with London Councils is that facilities costs (effectively rent, utilities, service charges) are based on headcount. As mentioned above as staffing levels are below MTFS, there is a positive cost variance.

   iii. **Legal and Professional** – these costs are below MTFS as third party fund launch costs primarily legal and investment consulting are now being charged to the funds when launched. It is important to note that although fund launch costs are to be charged to funds, the expenses are funded by LCIV and so there is a cash outflow from LCIV that will require careful treasury management.

5. In respect of service fees, the following amounts are outstanding from 8 boroughs as of 5th September :-

London Borough of Barnet (GBP)	90,000
London Borough of Camden (GBP)	90,000
London Borough of Croydon (GBP)	90,000
London Borough of Ealing (GBP)	90,000
Royal Borough of Greenwich (GBP)	90,000
Royal Borough of Kensington & Chelsea (GBP)	90,000
London Borough of Newham (GBP)	90,000
Wandsworth London Borough Council (GBP)	90,000
	720,000

Quarterly MTFS

6. The MTFS by quarter is set out in the table below. The Committee is asked to note that it reflects the incidence of costs increasing quarter on quarter as headcount rises together with the increasing use of third party costs as the operating model and systems are built out.

7. Fund launches were scheduled as follows:

    - Global Equity I - September £550m
    - Global Equity II – December £300m
    - Fixed Income - March £600m

2017/18 BUDGET - BY QUARTER	Q1	Q2	Q3	Q4	2017/18
INCOME					MTFS
Service Charge	200,000	200,000	200,000	200,000	800,000
Development Funding Charge	600,000	600,000	600,000	600,000	2,400,000
Management Fee	255,538	295,738	340,276	359,026	1,250,576
Total Income	1,055,538	1,095,738	1,140,276	1,159,026	4,450,576
EXPENSE					
Staff costs	484,621	575,271	629,164	629,164	2,318,220
Facilities	89,814	89,814	89,814	89,814	359,256
Legal and Professional	176,500	351,500	351,500	351,500	1,231,000
Total Travel and Sub/Prof Fees	16,844	16,844	16,844	16,844	67,375
Total Technology	12,115	98,781	98,781	98,781	308,458
Total Data Feed Costs	27,500	27,500	27,500	27,500	110,000
Total Operating Expenses	807,393	1,159,710	1,213,603	1,213,603	4,394,309
Operating Profit	248,144	-63,972	-73,327	-54,577	56,267
Depreciation	460	460	460	460	1,842
Interest Income	3,750	3,750	3,750	3,750	15,000
Net Profit	251,434	-60,683	-70,038	-51,288	69,425

8. The Committee will recall that it was agreed in the MTFS that the Development Funding Charge was set at £75,000 for the financial year 2017/18, and that this was to be billed in two tranches, £50,000 in April 2017 and the balance of £25,000 to be billed in December 2017, subject to the financial position and the business requirements of LCIV at that time. The rationale for splitting the DFC into two billing cycles was to ensure that LCIV raised invoices only to cover anticipated costs in the current financial year and not to generate a large financial surplus. It would be possible to carry the surplus forward to future financial periods, but as LCIV is subject to Corporation Tax any profit in the financial period would therefore be charged to Corporation Tax. However, as a consequence of the operating losses incurred in 2016/2017, much of the potential Corporation Tax would be reduced.

9. As explained above LCIV has a surplus of £592k compared to the MTFS of £222k for the four months to July and it is possible that the incidence of costs in the remainder of

the year may take place later than scheduled in the MTFS. If this situation occurs a larger surplus may arise based on the scheduled billing

10. The Committee is asked to note that a revised forecast for the year will be presented to the next Committee meeting in December where a recommendation will be made as to whether the balance of the DFC should be billed based on the actual and anticipated costs experience.

Recommendation

11. The committee is recommended to note and discuss the contents of this report.

Section 2. An update to the Committee on the LCIV staff pension scheme

12. At the Committee meeting in July, members were advised as to the status and operation of the LCIV pension scheme that is being administered through the City of London pension fund.

13. Following the completion of the financial statements of LCIV for year end March 2017, it was agreed that LCIV staff pension scheme arrangements should be reviewed in light of the funding requirements of the scheme, the accounting impact of FRS102 and the potential impact on the capital adequacy calculations of LCIV.

14. Meetings have been held with both Barnett Waddingham, the Scheme's Actuary, and Deloitte, LCIV's Auditor, to discuss the operation of the pensions scheme and options available. Barnett Waddingham are now finalising a report, which includes an assessment of potential options, and this will be presented to the LCIV board on 22nd September following which an updated proposal on pension arrangements will be presented to this Committee for discussion at its next meeting in December.

15. The analysis below is intended to provide additional information to the Committee which will form the basis of the report to the Board.

Background

16. The London CIV became an employer in the LGPS in September 2015. At outset therefore it had zero assets and liabilities but started to accrue liabilities and corresponding assets as staff joined the organisation and became members of the LGPS. Some staff members had accrued pensions in previous employments and some transferred these benefits into the LGPS, increasing both the assets and liabilities for the London CIV in the City of London Fund.

17. Scheme members only have the option of transferring in previous pension benefits in the first 12 months of joining the LGPS. The terms of converting the transfer value into LGPS benefits is set nationally by the Government Actuary across all LGPS Funds. The assumptions underlying the conversion terms are different to both funding valuation and accounting valuation assumptions. However they are much closer to the funding valuation assumptions than accounting assumptions.

18. Thus when an LGPS Fund receives a transfer value which is then converted into additional LGPS pension benefits, the resulting value of the additional liabilities in the LGPS Fund and the assets received should, as a broad rule of thumb, be relatively close to what would be valued on the funding basis and so no additional funding deficit

arises. This is a broad generalisation and depends on the age of the individual and other factors. However on an accounting basis the additional liabilities are almost certainly going to be higher than the additional assets received and so each transfer in will increase the accounting deficit.

19. However, there is one aspect which is particular relevance to staff who are transferring in benefits from a previous LGPS Fund with benefits earned before 31 March 2014. There some very complicated rules but broadly speaking they get day for day service in the new LGPS Fund. The transfer value paid by the former Fund will be based on final pay in that Fund whereas the benefits that are awarded in the new Fund will be based on their new pay.

20. So, for example, if the individual's new pay is say 10% higher than they pay in their former employment then they are awarded benefits that cost 10% more than the transfer value received. This only applies to benefits earned before 1 April 2014. CARE benefits earned after 31 March 2014 transfer across at face value.

Accounting entries

21. The following tables are lifted from Barnett Waddingham's accounting valuation report as at 31 March 2017 for the LCIV. The first table shows the changes in liabilities and the second table shows the change assets for accounting purposes.

Reconciliation of opening & closing balances of the present value of the defined benefit obligation	Year to 31 Mar 2017 £000s	Period to 31 Mar 2016 £000s
Opening defined benefit obligation	**203**	**-**
Current service cost	162	43
Interest cost	29	2
Change in financial assumptions	436	5
Change in demographic assumptions	-	-
Experience loss/(gain) on defined benefit obligation	412	24
Liabilities assumed / (extinguished) on settlements	-	-
Estimated benefits paid net of transfers in	685	114
Past service costs, including curtailments	-	-
Contributions by Scheme participants and other employers	75	15
Unfunded pension payments	-	-
Closing defined benefit obligation	**2,002**	**203**

Reconciliation of opening & closing balances of the fair value of Fund assets	Year to 31 Mar 2017 £000s	Period to 31 Mar 2016 £000s
Opening fair value of Fund assets	**159**	**-**
Interest on assets	22	2
Return on assets less interest	97	2
Other actuarial gains/(losses)	-	-
Administration expenses	-	-
Contributions by employer including unfunded	133	26
Contributions by Scheme participants and other employers	75	15
Estimated benefits paid plus unfunded net of transfers in	685	114
Settlement prices received / (paid)	-	-
Closing Fair value of Fund assets	**1,171**	**159**

22. The key numbers to focus on are the “Estimated benefits paid net of transfers in” in both tables – this is the cash received in respect of transfers in. The “Experience loss (gain) on defined benefit obligation” in the first table is the additional liability due to the benefits awarded from those transfers in being given a higher value on the accounting basis than the transfer basis. The relatively higher number for 2016/17 reflects the much lower discount rates at March 2017 compared to March 2016.

23. Another point worthy of note is how the Current Service Cost in the first table for 2015/16 (£43k) compares with the employer contributions in the second table (£26k). If the accounting basis was the same as the funding basis then these numbers would be the same. However the lower discount rates underlying the accounting basis puts a higher value on the employer’s share of the extra accrual of benefits during the year than the funding basis and so adds to the deficit. This is not unusual and is what happens in just about all LGPS employer accounting reports. The gap increases for 2016/17.

24. In the long term and assuming asset returns exceed corporate bond yields as expected, both these contributions to the accounting deficit should be offset by positive “Return on assets less interest” numbers. However this could take several years to materialise and of course is not guaranteed.

Recommendation

25. The Committee is asked to note the above progress report and that a final report will be presented at the next PSJC meeting.

Section 3. Regulatory Capital

26. As a FCA regulated entity, the Company is required to maintain sufficient regulatory capital as determined for a full scope Alternative Investment Fund Manager ('AIFM'). The amount of capital required is determined by the higher of one quarter of annual expenditure or a certain percentage of actual assets under management (0.02% in excess of Euro250,000). A formal calculation is submitted to the FCA on a quarterly basis and a summary of the Regulatory Capital Statement as at 30th June 2017 is given below.

27. Regulatory Capital Statement as of 30th June 2017

Tier 1 Regulatory Capital	£3,479k
Own Funds Requirement	£1,053k
Surplus Capital	£2,426k

Recommendations

28. The Committee is recommended to note the regulatory capital position as at 30 June 2017

Financial Implications

29. The financial implications are contained within the body of the report.

Legal implications

30. There are no legal implications for the Committee that have not been considered in the report.

Equalities implications

31. There are no equalities implications for the committee.